This document is scheduled to be published in the
Federal Register on 06/30/2023 and available online at
federalregister.gov/d/2023-13890, and on **govinfo.gov**

[4830-01

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9976]

RIN 1545-BO91

Additional Guidance on the Transition from Interbank Offer Rates to Other Reference Rates with Respect to the Interest Rates of a Foreign Bank

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains additional final regulations that provide guidance on the transition away from the use of interbank offer rates (“IBORs”) to other reference rates. Specifically, this regulation provides the replacement rate for the IBOR presently used in the published rate election, which may be used by taxpayers to determine the amount of interest expense attributable to their excess U.S.-connected liabilities and allocable to income that is effectively connected with the conduct of a trade or business within the United States (“ECI”). The final regulations will affect foreign banks that have income that is ECI.

DATES: Effective date: This regulation is effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability date: For dates of applicability, see § 1.882-5(f)(3).

FOR FURTHER INFORMATION CONTACT: D. Peter Merkel or Caleb W. Trimm, (202) 317-6938 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations that provide for the replacement of the 30-day IBOR rate presently referenced by § 1.882-5(d)(5)(ii)(B) with the Secured Overnight Financing Rate ("SOFR") of the same tenor, plus a fixed spread adjustment.

I. Discontinuation of IBORs and Transition to SOFRs

The London Interbank Offered Rate ("LIBOR") is an interest rate benchmark that was the dominant reference rate used in financial contracts, at one point serving as the benchmark for more than $200 trillion of contracts worldwide. On July 27, 2017, the Financial Conduct Authority, the United Kingdom regulator tasked with overseeing LIBOR, announced that publication of all currency and term variants of LIBOR, including the U.S. dollar LIBOR ("USD LIBOR"), may cease after the end of 2021. On March 5, 2021, the administrator of LIBOR, Intercontinental Exchange (ICE) Benchmark Association, announced that publication of the overnight, one-month, three-month, six-month, and 12-month USD LIBORs would cease following the LIBOR publication on June 30, 2023. The ICE Benchmark Association will continue to publish an unrepresentative synthetic USD LIBOR in one-month, three-month, and six-month tenors until September 30, 2024.[1] Publication of all other currency and tenor variants of LIBOR (including the one-week and two-month USD LIBOR) ceased following the LIBOR publication on December 31, 2021.

The Alternative Reference Rate Committee ("ARRC"), whose ex officio members include the Board of Governors of the Federal Reserve System, the Department of the Treasury ("Treasury Department"), the Commodity Futures Trading

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[1] The synthetic USD LIBOR will be the Term SOFR of the same tenor (published by the Chicago Mercantile Exchange Group Benchmark Administration, Ltd.), plus a fixed spread adjustment of 0.11448%, 0.26161%, or 0.42826% for the one-, three-, and six-month tenors, respectively. Financial Conduct Authority, *Article 23D Benchmarks Regulation Draft Notice of Requirements* (April 3, 2023), https://www.fca.org.uk/publication/libor-notices/article-23d-benchmarks-regulation-usd-draft-notice-requirements.pdf. This rate is not considered representative because it uses a synthetic methodology to determine rates instead of the panel bank methodology that has historically been used to determine IBORs.

Commission, and the Office of Financial Research, was convened by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York to identify alternative reference rates that would be both more robust than USD LIBOR and that would comply with standards such as the International Organization of Securities Commissions' "Principles for Financial Benchmarks." In 2017, the ARRC identified a SOFR-based rate as its recommended replacement for LIBOR.

In 2021, the ARRC recommended the forward-looking term SOFRs published by the Chicago Mercantile Exchange Group Benchmark Administration, Ltd. in one-month, three-month, and six-month tenors. The ARRC has also recommended static spread adjustments to each of those tenors to adjust for the fact that SOFRs are risk-free rates, while IBORs include an element of bank credit risk. The static spread adjustments are based on the historical median over a 5-year lookback period calculating the difference between USD LIBOR and compounded averages of SOFR, set on March 5, 2021.[2] The recommended static spread adjustment for one-month SOFR is 0.11448%.

To support the transition away from USD LIBOR, the ARRC has published recommended fallback language for inclusion in the terms of certain cash products. Contracts governed by U.S. law that reference USD LIBOR but that do not have any (or that have inadequate) fallback provisions are generally required by the Adjustable Interest Rate Act ("LIBOR Act"), Pub. L. 117-103, div. U, to use the SOFR of the same tenor, plus a static spread adjustment. The static spread adjustments to SOFR for each USD tenor required by the LIBOR Act are the same as those recommended by the ARRC.

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[2] For an explanation of the SOFR averaging calculation, *see* Federal Reserve Bank of New York, *Additional Information About the Reference Rates Administered by the New York Fed*, https://www.newyorkfed.org/markets/reference-rates/additional-information-about-reference-rates.

II. Regulatory Background

The transition from IBORs to SOFRs or other reference rates may give rise to various tax issues. To minimize market disruption and facilitate an orderly transition in connection with the discontinuation of LIBOR and other IBORs, the Treasury Department and IRS published proposed regulations (REG-118784-18) in the **Federal Register** (84 FR 54068) on October 9, 2019 ("2019 Proposed Regulations").

One issue addressed by the 2019 Proposed Regulations was the election provided by § 1.882-5(d)(5)(ii)(B). A foreign corporation that has a U.S. branch or other trade or business within the United States applies § 1.882-5 to determine its interest expense allocable under section 882(c) to its ECI. If a foreign corporation uses the method described in § 1.882-5(b) through (d), that foreign corporation could have liabilities attributable to its U.S. branch (U.S.-connected liabilities) that exceed its U.S.-booked liabilities (excess U.S.-connected liabilities). When a foreign corporation has excess U.S.-connected liabilities, § 1.882-5(d)(5)(ii)(A) entitles the foreign corporation to increase its interest expense allocable to its ECI in an amount determined by reference to the average U.S.-dollar borrowing cost on all U.S.-dollar liabilities other than its U.S.-booked liabilities. If the foreign corporation is a bank, it may elect under § 1.882-5(d)(5)(ii)(B) to use a published average 30-day LIBOR for the year rather than the actual rate computed under § 1.882-5(d)(5)(ii)(A). Because use of that election will no longer be possible when LIBOR is phased out, the 2019 Proposed Regulations included a proposal to replace 30-day USD LIBOR referenced in § 1.882-5(d)(5)(ii)(B) with a yearly average SOFR. Because SOFR is an overnight risk-free rate, the Treasury Department and the IRS acknowledged that the yearly average SOFR was likely to result in a lower rate than the 30-day LIBOR calculation previously allowed under § 1.882-5(d)(5)(ii)(B) and requested comments on whether another rate might be more appropriate.

Following publication of the 2019 Proposed Regulations, the Treasury Department and the IRS received one comment regarding the proposal to use yearly average SOFR in place of 30-day USD LIBOR for the election available under § 1.882-5(d)(5)(ii)(B). The comment noted two key differences between 30-day LIBOR and the yearly average SOFR, which the commenter stated made the yearly average SOFR an inappropriate substitute for 30-day LIBOR. First, SOFR is a risk-free rate, while LIBOR is an unsecured rate. Second, SOFR is an overnight rate, while the 30-day LIBOR is a one-month rate. The comment noted that SOFR removes the credit risk premium and term liquidity premium from the cost of borrowing as compared to 30-day LIBOR. The comment, however, did not identify a more reasonable substitute for 30-day LIBOR at that time and recommended that the Treasury Department and the IRS defer finalizing the proposed rule under § 1.882-5(d)(5)(ii)(B) because a yearly average SOFR calculation was not a reasonable replacement rate for 30-day USD LIBOR.

On January 4, 2022, the Treasury Department and the IRS published final regulations (TD 9961) in the **Federal Register** (87 FR 166) relating to the transition from IBORs to other reference rates ("2022 Final Regulations"). The 2022 Final Regulations did not finalize the proposed change to § 1.882-5(d)(5)(ii)(B). Instead, the Treasury Department and the IRS sought additional comments regarding the appropriate replacement rate for 30-day USD LIBOR for the purpose of the election under § 1.882-5(d)(5)(ii)(B).

Following the publication of the 2022 Final Regulations, the Treasury Department and the IRS received one additional comment regarding the appropriate replacement rate for the 30-day USD LIBOR rate referenced by § 1.882-5(d)(5)(ii)(B).

This comment is available for public inspection at *https://www.regulations.gov* or upon request. No public hearing was requested, and none was held. After consideration of the comments, the Treasury Department and the IRS adopt the 2019 Proposed Regulation as amended by this Treasury decision ("final regulations").

Summary of Comments and Explanation of Revisions

I. Appropriate Replacement Rate for 30-Day LIBOR

In response to the request for additional comments in TD 9961, one comment was received relating to the 30-day USD LIBOR replacement in § 1.882-5(d)(5)(ii)(B). The comment made three recommendations for the final regulations under § 1.882-5(d)(5)(ii)(B).

A. One-Month Term SOFR Plus a Static Spread Adjustment

First, the comment recommended finalizing the regulation using the one-month term SOFR plus static spread adjustment of 0.11448% as recommended by the ARRC (which endorsed Term SOFR rates in June of 2021 and spread adjustments in October of 2021) and codified in the LIBOR Act (enacted in December of 2021). The comment noted that the one-month term SOFR plus a fixed spread adjustment accounts for some of the differences between SOFR and LIBOR rates and implied that one-month term SOFR plus static spread adjustment of 0.11448% is a more appropriate replacement than yearly average SOFR. The published rate election provides eligible taxpayers with administrative relief from the burden of calculating their actual borrowing rate, which is based on data maintained outside the United States.

The final regulations adopt this recommendation. The ARRC, whose ex officio members include the Treasury Department, has generally recommended that contracts referencing USD LIBOR adopt fallback provisions that reference the term SOFR of the same tenor, plus a static spread adjustment. The Treasury Department has supported the recommendations of the ARRC in prior guidance issued in Revenue Procedure 2020–44, 2020–45 I.R.B. 991 and the 2022 Final Regulations. In addition, contracts governed by U.S. law that have not voluntarily adopted such fallback provisions are generally required by the LIBOR Act to use the SOFR of the same tenor, plus the ARRC-recommended static spread adjustment, as a matter of law. Pub. L. 117-103, div. U. Accordingly, both the Treasury Department and the U.S. Congress have endorsed, or required, the use of a term SOFR of the same tenor, plus the ARRC-recommended static spread adjustment, as a replacement for term USD LIBORs. Because the published rate election available under § 1.882-5(d)(5)(ii)(B) references 30-day LIBOR, the one-month term SOFR (plus static spread adjustment) is the most appropriate replacement rate.

B. Alternative Method Approximating Actual Rate

The comment also recommended that the final regulations allow taxpayers to use a rate that reasonably approximates the bank's actual rate and that is consistently applied from year to year. This recommendation is based on the approach taken in regulations that were in effect from 1981 through 1996. TD 7749, 46 FR 1681 (Jan. 7, 1981) (codified at former § 1.882-5(b)(3)(i)(B)). This historical regulation provided that, if information needed to calculate the taxpayer's actual interest rate could not be reasonably obtained, then the taxpayer could determine its interest rate by applying any method that reasonably approximated its actual interest rate and that was consistently applied year over year, including, for example, approximating its interest rate by reference to 30-day LIBOR. *Id.* at 1684-85. The comment expressed concern that the one-month term SOFR plus static spread adjustment may be less than the actual cost of borrowing; however, for some taxpayers it may not be worthwhile or possible for the corporation to calculate its actual borrowing rate.

The final regulations do not adopt this recommendation. An approach based on a reasonable approximation of a taxpayer's actual interest would establish a different method for determining a taxpayer's borrowing rate that does not provide the certainty, accuracy, and simplicity of a published rate election. Additionally, the IRS would face significant challenges in administering such a rule. For example, the comment did not suggest any standard by which the IRS might determine whether a taxpayer's method is a reasonable approximation of its actual borrowing rate.

Finally, data from recent filing years indicates that the actual rate calculation is not a significant burden to taxpayers. For taxable years 2020 and 2021 (the most recent years for which data is available), a majority of foreign banks with excess U.S.-connected liabilities chose to calculate their actual rate rather than use the published rate election. In both years, approximately 80% of such taxpayers opted to calculate their actual rate, while less than 20% chose to use the published rate election available under § 1.882-5(d)(5)(ii)(B).

C. Mechanism for Endorsing Additional Replacement Rates

Finally, the comment recommended that the final regulations include a mechanism for identifying additional qualified alternative reference rates via Internal Revenue Bulletin, Revenue Procedure, or another similar notice. The final regulations do not adopt this recommendation. The Treasury Department and the IRS do not anticipate a need to name additional alternative reference rates, and, if the need does arise in the future, the Treasury Department and the IRS may prefer to propose any new alternative reference rate through the regulatory process.

II. Application of the Published Rate Election by the IRS in an Examination

If a taxpayer failed to file a timely return or incorrectly determined that it did not have excess U.S.-connected liabilities, § 1.882-5(d)(5)(ii)(B) allowed the Director of Field Operations to calculate the taxpayer's interest expense with respect to excess U.S.-connected liabilities using either the taxpayer's actual rate or the published rate provided by § 1.882-5(d)(5)(ii)(B). The final regulations amend this rule to require the Director of Field Operations to use the published rate in order to reduce the administrative burden of calculating the actual rate for both the IRS and taxpayers.

III. Transitional Rule For Taxable Years Including the Date of LIBOR Cessation

For a taxable year that begins before and ends after the USD LIBOR cessation date of June 30, 2023, a taxpayer that makes the published rate election available under § 1.882-5(d)(5)(ii)(B) must calculate a blended published rate average for the taxable year which uses the 30-day USD LIBOR for the portion of its taxable year ending on June 30, 2023, and the one-month Term SOFR, plus static spread adjustment, for the portion of its taxable year beginning on July 1, 2023.

IV. Applicability Date

These final regulations apply to taxable years ending after June 30, 2023.

Special Analyses

I. Regulatory Planning and Review – Economic Analysis

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. Regulatory Flexibility Act

The final regulations affect any foreign bank that has ECI and that has excess U.S.-connected liabilities, but which cannot reasonably calculate its actual borrowing rate. The number of small entities potentially affected by the final regulations is unknown; however, it is unlikely to be a substantial number because the final regulations only affect foreign banks that operate in the United States. In addition, data collected from Forms 1120-F, Schedule I filed in recent taxable years indicates that fewer than 100 total taxpayers are foreign banks with both ECI and excess U.S-connected liabilities. The data from Forms 1120-F, Schedule I shows that the number of foreign banks that elected to use the 30-day USD LIBOR rate to compute the interest expense attributable to their excess U.S.-connected liabilities varied from year to year. In some years, as many as 50 foreign banks made the election on Schedule I to use the 30-day USD LIBOR rate; in other years, fewer than ten taxpayers made that election. The Secretary has determined that the economic impact on any small entities affected by the final regulations is not significant.

The final regulations provide that the annual published rate election available under § 1.882-5(d)(5)(ii)(B) will be modified by substituting the one-month term SOFR, plus a static spread adjustment, for 30-day USD LIBOR. The rule does not require taxpayers to collect additional information to determine whether the taxpayer is eligible for the election. Additionally, the rule does not impose any new costs on taxpayers because it only replaces the published rate used for the purpose of the election and does not affect a taxpayer's obligation with respect to the information to be gathered and reported.

In accordance with the Regulatory Flexibility Act (5 U.S.C. 601 et seq.) the Secretary hereby certifies that these final regulations will not have a significant economic impact on a substantial number of small entities.

III. Section 7805(f)

Pursuant to section 7805(f), the proposed regulations (REG-118784-18) preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact on small business, and no comments were received.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. This regulation does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive order.

Statement of Availability of IRS Documents

IRS Notices and other guidance cited in this preamble are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at https://www.irs.gov.

Drafting Information

The principal authors of these regulations are D. Peter Merkel and Caleb W. Trimm of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, the Treasury Department and IRS amend 26 CFR part 1 as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for § 1.882-5 to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

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Section 1.882-5 also issued under 26 U.S.C. 882(c), 26 U.S.C. 864(e), 26 U.S.C. 988(d), and 26 U.S.C. 7701(l).

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Par. 2. Section 1.882-5 is amended by revising the fourth sentence of paragraph (a)(7)(i) and paragraphs (d)(5)(ii)(B) and (f) to read as follows:

§ 1.882-5 Determination of interest deduction.

(a) * * *

(7) * * *

(i) * * * An elected method (other than the fair market value method under paragraph (b)(2)(ii) of this section, or the published rate election in paragraph (d)(5)(ii) of this section) must be used for a minimum period of five years before the taxpayer may elect a different method. * * *

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(d) * * *

(5) * * *

(ii) * * *

(B) <u>Annual published rate election</u>--(<u>1</u>) <u>In general</u>. For each taxable year in which a taxpayer is a bank within the meaning of section 585(a)(2)(B) (without regard to the second sentence of section 585(a)(2)(B) or whether any such activities are effectively connected with a trade or business within the United States), the taxpayer may elect to compute the interest expense attributable to excess U.S.-connected liabilities by using the average published one-month Term Secured Overnight

Financing Rate published by the Chicago Mercantile Exchange Group Benchmark Administration, Ltd. (or any successor administrator) (“Term SOFR”) for the taxable year, plus a static spread adjustment of 0.11448%, rather than the interest rate provided in paragraph (d)(5)(ii)(A) of this section. A taxpayer may elect to apply the rate provided in this paragraph (d)(5)(ii)(B) on an annual basis and does not require the consent of the Commissioner to change this election in a subsequent taxable year. If a taxpayer that is eligible to make the published rate election either does not file a timely return or files a calculation with no excess U.S.-connected liabilities and it is later determined by the Director of Field Operations that the taxpayer has excess U.S.-connected liabilities, then the Director of Field Operations will apply the interest rate provided under this paragraph (d)(5)(ii)(B) to the taxpayer's excess U.S.-connected liabilities in determining interest expense.

(2) Transitional rule for taxable years including June 30, 2023. For a taxable year that includes June 30, 2023, a taxpayer that makes the annual published rate election must compute the interest expense attributable to excess U.S.-connected liabilities by ratably using the average 30-day U.S. dollar London Interbank Offered Rate for the portion of its taxable year ending on June 30, 2023, and the average one-month Term SOFR, plus a static spread adjustment of 0.11448%, for the portion of its taxable year beginning on July 1, 2023.

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(f) Applicability date--(1) General rule. Except as provided in paragraph (f)(3) of this section, this section is applicable for tax years ending on or after August 15, 2009. A taxpayer, however, may choose to apply § 1.882-5T, rather than applying the regulations in this section, for any taxable year beginning on or after August 16, 2008, but before August 15, 2009.

(2) [Reserved]

(3) Applicability date for published rate election. Paragraphs (a)(7)(i) and (d)(5)(ii)(B) of this section apply to taxable years ending after June 30, 2023. For taxable years ending before July 1, 2023, see § 1.882-5(d)(5)(ii)(B) (as contained in 26 CFR part 1, revised as of April 1, 2023).

Douglas W. O'Donnell,

Deputy Commissioner for Services and Enforcement.

Approved: June 19, 2023.

Lily Batchelder,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2023-13890 Filed: 6/29/2023 8:45 am; Publication Date: 6/30/2023]